The Outlook for European Economies

Feelings of a deceleration grow, yet the economy will remain resilient, especially private consumption

RYO YAMADA
ECONOMIC RESEARCH OFFICE: TOKYO
TAKAYUKI MIYADO
ECONOMIC RESEARCH OFFICE: LONDON

MUFG Bank, Ltd.
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1. Eurozone

1.1 Overview of the Eurozone Economy

The Eurozone's real GDP growth slowed to 0.2% QoQ in the April-June quarter. Growth was underpinned by private consumption, but there was an apparent dip in exports after the last-minute surge in exports to the UK just before the first Brexit deadline (29th March). A breakdown by country reveals real GDP growth was -0.1% QoQ in Germany, turning negative for the first time in three quarters owing to downward pressure from a decrease in exports despite solid domestic demand (Table 1). In France, growth remained unchanged from the previous quarter at 0.3% QoQ. Investment by the public and private sectors was solid, yet there was downward pressure from a fall in inventory investment. On the whole, real GDP growth also remained weak in Italy too as growth of domestic and external demand stayed flat at around zero.

Over the long term, the Eurozone's real GDP growth rate has remained at the low level of 0.2% QoQ for three out of the four quarters from July-September 2018 to April-June 2019. During this time, Germany has recorded two quarters of negative growth and Italy's growth rate has plateaued, also contracting for two quarters.

Table 1: Real GDP Growth in Major European Countries

(YoY, %)

	2018				2019	
	Q1	Q2	Q3	Q4	Q1	Q1
Eurozone	0.4	0.4	0.2	0.2	0.4	0.2
Germany	0.1	0.4	-0.1	0.2	0.4	-0.1
France	0.2	0.2	0.3	0.4	0.3	0.3
Italy	0.2	0.0	-0.1	-0.1	0.1	0.0
UK	0.1	0.4	0.7	0.2	0.5	-0.2

(YoY, %)

	2018 (actual)	2019 (forecast)	2020 (forecast)
Eurozone	1.9	1.2	1.4
Germany	1.5	0.6	1.4
France	1.7	1.3	1.4
Italy	0.9	0.2	0.7
UK	1.4	1.2	1.4

Source Eurostat, MUFG Bank Economic Research Office

The lack of growth in the Eurozone economy since 2018 is likely the result of a multitude of factors. In Europe, there is the confusion surrounding Brexit negotiations, as well as concerns

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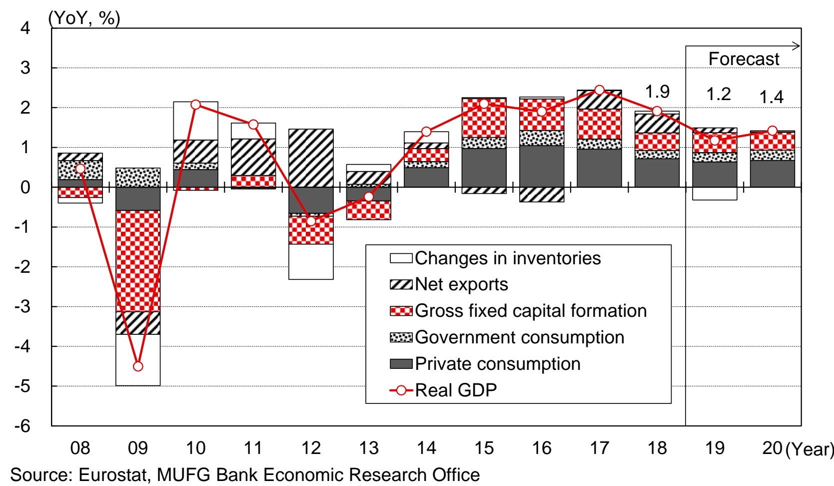
about Italy's fiscal situation. There is also a rise in uncertainty owing to a slowing of the Chinese economy and an escalation of trade friction between the US and China and the US and the EU. When all these factors are considered at once, it may give rise to a strong sense of caution about the future of European economies; however, the situation now is not the same as during the global financial crisis or the European debt crisis, when a financial emergency sparked severe and sudden economic downturns, and it is not clear there is any relation between these events and individual economic indicators.

A detailed comparison of economic indicators reveals labour, income and consumption are fairly robust but manufacturing-related indicators, such as production, are noticeably weak. A breakdown of the sluggish production data by country shows production is remarkably weak in Germany, the largest industrial nation in the region, and the slump in its automobile industry is worsening. As China's automobile market – the largest in the world – contracts by double-figures year-on-year in terms of the number of automobiles, this shrinking is said to be hitting German car makers, which boast the largest presence of foreign-affiliated companies. However, the fall in German car sales in China remains gradual as the year-on-year decrease is only slightly negative, and exports from Germany to China do not appear to be so sluggish when transport equipment is also taken into consideration. Instead, it is possible that the fall in German car sales could be a negative reaction to the pent-up demand for automobiles after the European debt crisis, considering the sales of automobiles in Western European countries, including those in the south (Italy and Spain), are falling by around 10% or less on a monthly basis. In addition, it is possible that complex factors are having a particularly strong impact on German car makers, such as a rise in uncertainty both inside and outside the region and inventory adjustments.

1.2 Key Points of the Outlook

Despite the sluggishness of the manufacturing sector and the continued presence of various sources of concern both inside and outside Europe as mentioned below, the future of the Eurozone as a whole is one of robust private demand, particularly private consumption, which will be supported by a strong labour market and wage growth. There is also expected to be an increase in government spending in major countries. Real GDP growth slowed to 1.2% YoY and was weighed down by the deceleration of external demand and inventory adjustments this year. Nevertheless, it is expected to recover to 1.4% YoY in 2020, achieving roughly the same pace as the potential growth rate (around 1.5% YoY) (Table 1). Meanwhile, concerns of a "no deal" Brexit are rising currently. If this does occur, the disruption to logistics and the slump in business and consumer sentiments will put downward pressure on both the Eurozone and UK economies and the impact will be unavoidable. Nevertheless, due to the imbalance in their reliance on each other as trading partners, it seems the Eurozone economy will avoid a recession.

Chart 1: Eurozone's Real GDP Forecast

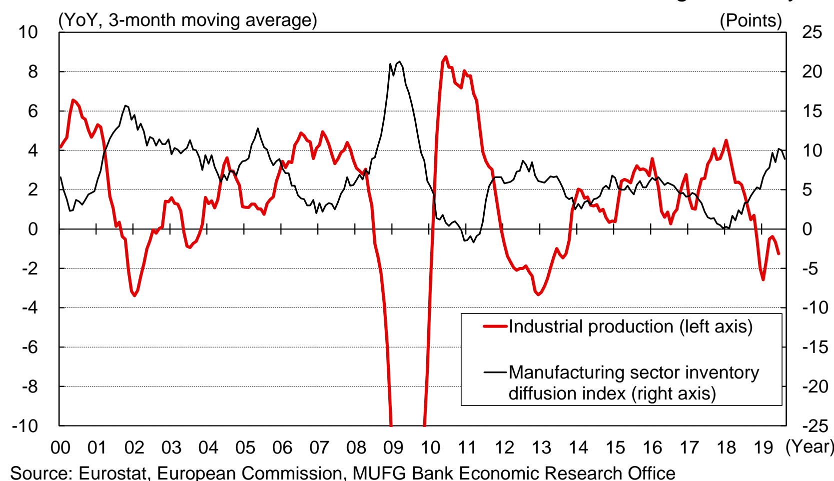


Source: Eurostat, MUFG Bank Economic Research Office

1.2.1 The Manufacturing Industry

Exports to regions outside the Eurozone fell on a QoQ basis in the April-June quarter seemingly owing to a dip in exports to the UK after a surge ahead of the initial date for Brexit at the end of March. However, when exports to China since 2018 are also included, it shows exports are firm on the whole. In addition, private consumption is robust and remains on an upward trend, despite a downturn in capital expenditure. Nevertheless, the Eurozone's manufacturing production – led by Germany – is stagnating, and it is thought that continued inventory adjustments are weighing on the economy. In fact, the contribution to growth by inventory investment, which is determined by the Eurozone's real GDP growth rate, was negative for two consecutive quarters from October-December 2018 to January-March 2019 (Chart 2). There is a strong possibility that its contribution in the April-June quarter will also be negative based on the current inventory DI (diffusion index) and industrial production. In light of the level of deterioration of the inventory DI, it appears the continued negative impact from inventory adjustments is unavoidable for the time being; however, the cyclical trend of the inventory DI in the past and predications from various industries suggest this negative impact will slowly fade at from the end of this year and the impact on the economy next year will be limited.

Chart 2: Eurozone's Industrial Production and Manufacturing Inventory DI



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

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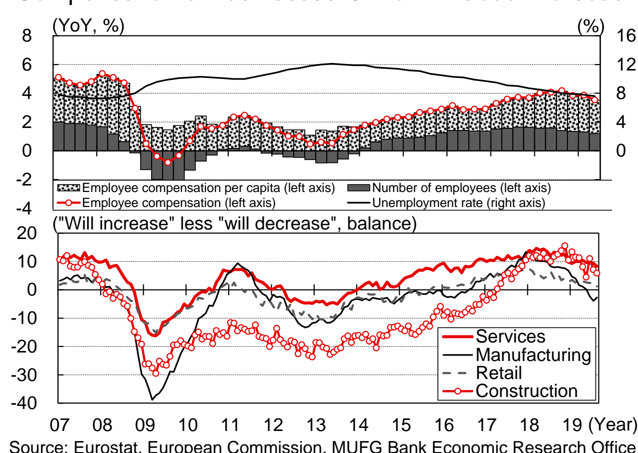
1.2.2 Private Consumption and Capital Expenditure

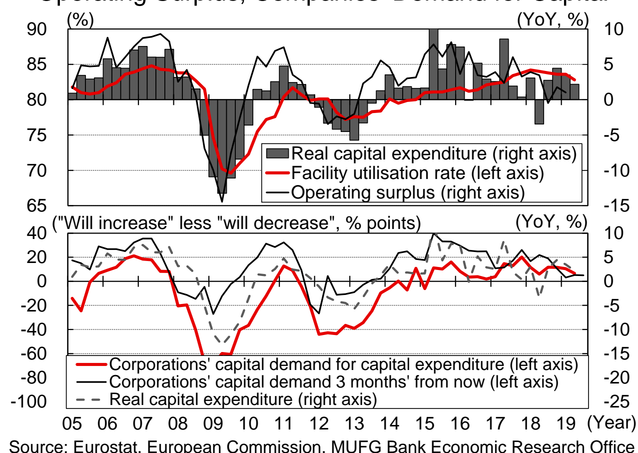
The situation surrounding private consumption – the largest GDP component on the demand side – reveals the unemployment rate has fallen close to pre-global financial crisis levels and corporations' employment forecasts remain at high levels, particularly that of the service sector, which accounts for three quarters of all employees (Chart 3). The growth of employee compensation per capita is still robust and, looking ahead to next year, it appears the labour market and wage growth will remain strong and private consumption will increase based on the high level of consumer confidence, which will result in continued support for the expansion of the economy. Furthermore, the facility utilisation rate is still at a high level, this phase of inventory adjustments will probably end next year and demand for capital related to corporations' capital expenditure still appears to be firm (Chart 4). Taking this into account, it is likely these factors will underpin economic growth.

Chart 3: Eurozone Unemployement Rate, Employee Compensation & Businesses' 3-Month Labour Forecast



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

Chart 4: Eurozone Facility Utilisation Rate, Real Capex, Operating Surplus, Companies' Demand for Capital



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

1.2.3 Remaining Sources of Concern

There is a lingering, deep-seated feeling of uncertainty related to politics both inside and outside the region in the Eurozone due to the meandering Brexit negotiations, which are one of the causes of the sluggish growth of foreign demand since the latter half of 2018; friction over trade between the US and China; and political issues in Italy. As discussed later, the Brexit situation is exceptionally unclear. On top of this, the US announced its fourth round of additional tariffs against China and China retaliated with its own measures. There are concerns within the Eurozone that if the economies of the countries affected by these issues slow, there will be a downturn in foreign demand. In addition, the European Parliament elections that took place earlier this year were also unable to bring balance to the political instability in Europe. German defence minister Ursula von der Leyen will be appointed European Commission president when Jean-Claude Juncker steps down at the end of his term on 31st October after only winning nine votes more than the necessary number required to secure a majority in the European Parliament (President Juncker won a majority of 48 votes). This result suggests the major political parties are not aligned in their views. Turning to the political situation of individual countries, League, the right-wing party who form part of the coalition government in Italy, called for a vote of no confidence in August, thereby ending their coalition with their partners, the Five Star Movement. Following the coalition split, Five Star Movement formed a new coalition government with the left-wing Democratic Party; however, this has not brought an end to the concerns regarding Italy's political situation due to the difference between the

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new coalition partners' policies. In Germany, concerns are rising as the Social Democratic Party (SPD) – the government's junior coalition partner – experienced huge losses at the European Parliament elections and there are increased expectations that the party will quit the coalition government, sparking a general election. On the whole, the result of the European Parliament elections is a decline in concerns that the extreme policies of Eurosceptic parties will grow increasingly radical, yet there is a still a possibility that the political instability of certain countries will weigh on the Eurozone economy, and it is important to continue to pay close attention to the outcome of political events both inside and outside the region.

1.2.4 Monetary Policy Outlook

At the press conference following its meeting on 25th July, the Governing Council of the European Central Bank (ECB) shared its view of the economic situation: "the risks surrounding the euro area growth outlook remain tilted to the downside, reflecting the prolonged presence of uncertainties related to geopolitical factors, the rising threat of protectionism, and vulnerabilities in emerging markets". Due to this situation, the Bank's forecast for the key ECB interest rates was changed from "remain at their present levels at least through the first half of 2020" to "remain at their present or lower levels at least through the first half of 2020". By completely revising its "monetary easing exit strategy" up until now and suggesting interest rate cuts in the future, the ECB has once again changed its stance to one of clear monetary easing. At the same time, the possibility of easing policies other than an interest rate cut is increasing as ECB members indicated they are considering additional easing policies, such as reinforcing their forward guidance, mitigating measures for negative interest rates (system for reserve remuneration) and relaunching the asset purchase programme. Furthermore, the ECB plans to raise the inflation rate, which has been sluggish, and stated it is "determined to act in line with its commitment to symmetry in the inflation aim", suggesting it will allow the inflation rate to exceed its target of "below, but close to, 2%" as the current CPI is between around 1% and 1.5%: well below the ECB's target. In light of the ECB's acknowledgement of the soft economic indicators and sluggish inflation rate, the ECB is expected to lower interest rates (deposit facility rate -0.4% → -0.5%) in September before President Draghi's term comes to an end and discuss a policy package comprised of various easing policies, such as relaunching its asset purchase programme, as they suggested (confirmed in the minutes from the meeting in July: "now the statement says that if we are to lower interest rates, that will come with mitigating measures. That is quite clear").

Looking ahead, the ECB will become more cautious about lowering rates from October given that the US Federal Reserve Board is expected to maintain interest rates after another interest rate cut of 0.25% in September and assuming the Eurozone economy will return to a pace of gradual expansion at some point next year. In Europe, there is awareness of the side effects of cutting interest rates further into negative territory, such as the impact on the intermediary function of financial institutions. However, financial markets have factored in a large rate cut by the US which has led to expectations in Europe of a further rate cut of around -0.4% points between now and mid-2020 by the ECB. German and French 10-year government bond yields are actually significantly lower than the ECB's interest rates (Chart 6). If the US does decide to lower interest rates, the subsequent decrease in the difference between interest rates will lead to euro appreciation, which is expected to have an impact on Eurozone exports and will result in the undeniable possibility that the ECB will also have to carry out an additional rate cut.

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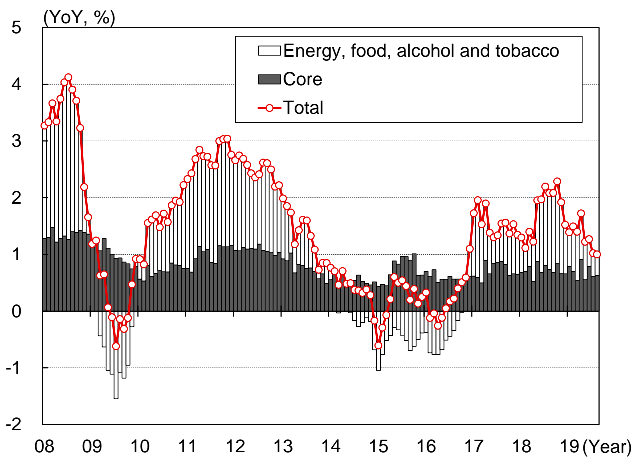
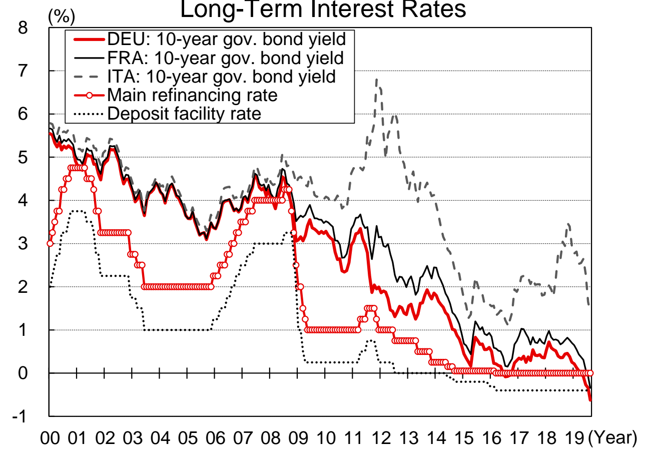
Chart 5: Eurozone Consumer Price Index



Source: Eurostat, MUFG Bank Economic Research Office

Chart 6: ECB's Interest Rates and Long-Term Interest Rates

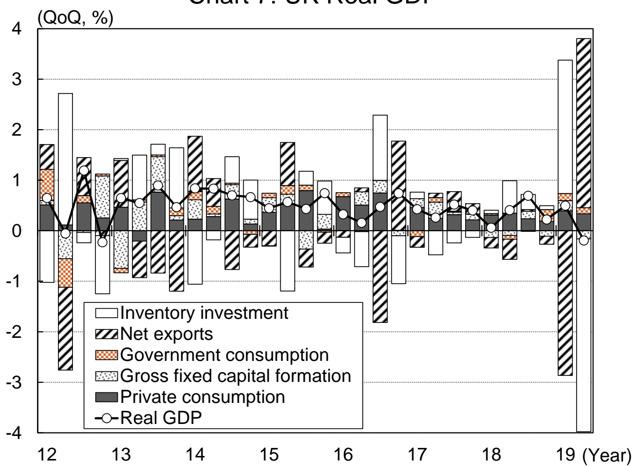


Source: Bloomberg, MUFG Bank Economic Research Office

2. UK

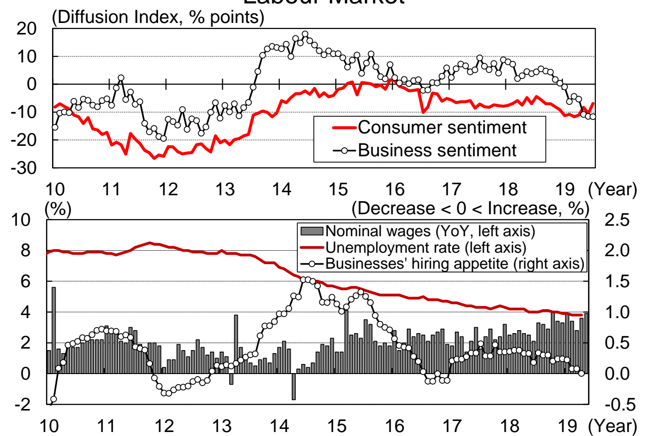
The UK real GDP growth rate was -0.2% QoQ in the April-June quarter, recording the first negative growth since October-December 2012 (Chart 7). However, growth was affected significantly by a dip in demand following the surge in the January-March quarter when businesses and households were stockpiling before the UK's initial plans to leave the EU on 29th March following warnings of a "no deal" Brexit. An average of those two quarters gives a real GDP growth rate of around 0.2% QoQ. Although the economy has slowed, it retains a certain amount of its resilience.

Chart 7: UK Real GDP



Source: Office for National Statistics, MUFG Bank Economic Research Office

Chart 8: UK Consumer and Business Sentiment and Labour Market



Source: ONS, Eurostat, MUFG Bank Economic Research Office

Currently, there is some notable weakness in the corporate sector, particularly the manufacturing sector, but the economy is supported firmly by the household sector's stable rise in income and robust consumption – following a common global pattern. Consumer and business sentiment worsened temporarily after April, when there were increased concerns of a "no-deal" Brexit. However, after the decision to extend the exit day until the end of October, there was a clear split with businesses remaining cautious and consumer sentiment improving (Chart 8). The reason for this seems to be that the new departure date was quite far off, but more fundamentally, it was due to the historically strong labour market and wage situation. Since the unemployment rate was low at 3.9% in the April-June quarter and growth of nominal

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employee compensation remains at a high level of 4.1% YoY, the feeling of instability owing to Brexit is not yet reflected in consumer behaviour. On the other hand, the corporate sector adopted a wait-and-see attitude to investment following the referendum in 2016 where the UK voted to leave the EU, and there appears to be a clear downward trend in appetite for capital expenditure in relation to the level of spare production capacity as corporations review their investment strategies for after Brexit (Chart 9).

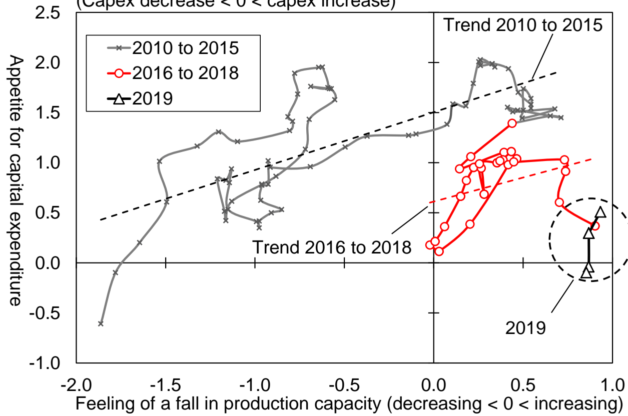
This situation is suppressing businesses' capital expenditure as the future is difficult to predict, yet the UK economy is being supported by businesses' plans for hiring, which is their alternative measure to capital expenditure for the time being. Based on the signs that corporations are finally taking a more cautious stance towards labour due to the increased uncertainty surrounding Brexit, the UK should no longer be considered as stable as other developed countries. In other words, the outcome of Brexit is crucial as it will affect corporations' investment and employment attitudes in the long term.

Since Boris Johnson became prime minister on 24th July, uncertainty has been increasing and there are various possible outcomes for Brexit (Chart 10). With a cabinet the majority of whom support a "hard Brexit" and a willingness to leave the EU with no deal, Prime Minister Johnson has pushed forwards with trying to renegotiate the Withdrawal Agreement while also making Brexit preparations, including economic policies. Meanwhile, a map of seats in Parliament reveals the ruling party's majority is in contention as they have a majority of just one seat (based on the number of votes excluding the Speaker's Chair). While the EU refuses to renegotiate the Withdrawal Agreement, the opposition parties anticipate rebels appearing from the Conservative Party who aim to block a "no deal" Brexit and they may take action as soon as September. However, they are currently responding to Prime Minister Johnson's decision to prorogue parliament from 9th September to 13th October. This means that the possibility of a "no deal" Brexit has increased abruptly; the necessary number of days Parliament is open to ratify a withdrawal agreement has been reduced and time may run out before a decision is reached. Looking ahead, any developments are difficult to predict rationally and the situation appears to be dependent on political bargaining.

Dividing the possible scenarios into "no deal" Brexit and "other" (Brexit with a withdrawal deal or revoking Article 50), in the former scenario, it is highly likely the real economy will sink into negative growth of just over -1% YoY in 2020 owing to disrupted logistics, GBP depreciation and inflation, and a decline in business and consumer sentiments. On the monetary policy front, Governor of the Bank of England Mark Carney said "it's more likely we would provide some stimulus" in the case of a "no deal" Brexit. As a result of this statement, the Bank of England (BoE) is expected to cut rates to 0.25% (a decrease of 0.5% points) in the event of "no deal", but its effectiveness at softening an economic recession will probably be limited.

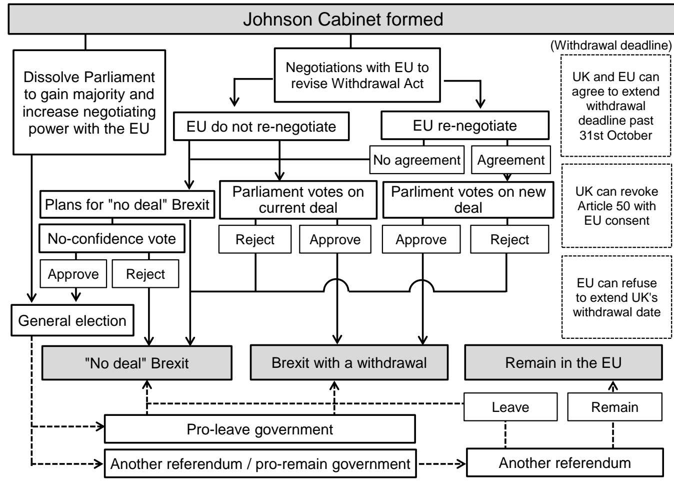
On the other hand, if the UK manages to avoid a "no deal" Brexit by some other route (main scenario), the real GDP growth rate is expected to gradually increase to 1.2% YoY in 2019 and 1.4% in 2020 as corporations go ahead with some of the capital expenditure which they had postponed up until now due to their wait-and-see approach, as well as expansive fiscal policies which the government is expected to enact. Turning to monetary policy, inflation will remain at a high level within the region of the 2% YoY target and the GBP will continue to appreciate. As a result, it is likely the BoE will maintain its current monetary policy (0.75%).

Chart 9: UK Businesses' Perception of Production Capacity and Capital Expenditure Appetite



Source: Bank of England, MUFG Bank Economic Research Office

Chart 10: Main Brexit Options



Source: Various, MUFG Bank Economic Research Office

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Rei Tsuruta Tel: +81-(0)3-3240-3204

Written by Ryo Yamada < riyou_yamada@mufg.jp>

Takayuki Miyado <takayuki.miyado@uk.mufg.jp>

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